MARTIN
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The Tower of Basel

With the global financial world in disarray in 2009, the major economies of the world, the so-called "G-20," returned to the communal refuge of monetary sanctuary, Basel, Switzerland. Home of the Bank for International Settlements, this quaint historic town is about the size of our own city of Elkhart. Nestled between the borders of Germany and France in the northeast corner of Switzerland, Basel is the unlikely place where central bankers of the world gather to propose, under the auspices of the Basel Committee on Banking Supervision, voluntary general regulations for the safe playing of the global money game. These accords, of which there have been three thus far, date back to 1988 and focus primarily on reining in the recalcitrant by establishing minimum capital requirements. Basel II, published in 2004 with implementation expected by 2008, sought to tighten capital requirements for banks that held riskier assets. Too little, too late, it failed miserably. The Basel III Accord was developed in response to the deficiencies in financial regulation revealed by the financial crisis of 2007–08. Originally scheduled to be implemented between 2013 and 2015, the inability to reach a consensus resulted in postponement of the effective date to March 2018 (recently extended again to March 2019). As the Basel accords attest, regulation rarely preempts potentially serious problems; it is relegated to containing them after everyone's worst fears have been realized.

The regulators face a dilemma: Focus on any one measure and the banks will find a way to get around it. Tempted as they are to add further measures to restrict wiggle room (Basel III uses both asset risk weights and a leverage ratio), with each new measure introduced, the more complex the system becomes. Basel I rules numbered 30 pages; II, 347; and III, 616. The Glass-Steagall Act of 1933, which separated commercial and investment banking, was a concise 37 pages. In 2010, Dodd-Frank ran to 848, and may spawn another 30,000 pages of detailed rulemaking by various agencies. By one authority, in 1935 one American financial regulator oversaw three banks; today the ratio is three regulators per bank. There seems to be an inverse relationship between regulation and stability!

With the best and the brightest following the lead of Willie Sutton, outgunned bureaucratic regulators are playing a loser's game, forever scrambling to keep pace with the complexity of the financial firms they are charged with supervising. With an increasingly complex and interdependent man-made global economic system (naturally evolving systems tend to be far more stable), tail risk grows apace in part because it can no longer be defined or measured. It is also the nature of such systems to migrate toward disequilibrium—the opposite of their intended effect.

The Basel Accords are a metaphor for much of what ails organizations globally.

Overlay that template on almost any organizational construct today and you begin to envisage the expansiveness of the metaphor. Lately all fingers are pointing at centrally controlled China as the epicenter of global destabilization. The colossus has become unwieldy, even though the protagonist and the regulators are one in the same. When China sneezes—or so it appears—the world catches a cold.

To frame the China paradox in sharper relief, a simple anecdote from neighboring Russia might do. A friend of mine recounted traveling through the heart of the Soviet Union sometime before its dissolution in 1991. While driving near Moscow, he and his hosts encountered heavy rain. In the midst of the deluge he noticed that almost all of the cars had pulled to the side of the road, their owners racing through the downpour to their trunks to retrieve an object. It was explained to him that it is in the windowless trunk where windshield wiper blades are out of reach of vandals. An object lesson in the complexity of advanced, centrally controlled economic systems and the potential for amplification of errors, it seems there was a governmental miscalculation or oversight resulting in an acute shortage of wiper blades. With supply being far below inelastic demand, wiper-less car owners would openly steal blades left on their comrades' unattended wiper arms!

About the time of my friend's return stateside, iconic academic Paul Samuelson[1] was predicting that the Soviet Union's economy would overtake the U.S. by 2010 because the "Soviet central planning system was in some ways more efficient than the U.S. model … and is proof that, contrary to what many sceptics had earlier believed, a socialist command economy can function and even thrive." How could Samuelson, himself a metaphor for what sometimes constitutes conventional wisdom, have missed so simple a flaw in central-command systems? Free markets are as Samuelson described them save for one important consideration: With tens of millions of Adam Smith-like decision-makers, the probability of running out of windshield wiper blades is reduced enough to more than offset capitalism's disadvantages.

Returning to China, it is impossible to pinpoint what will be their figurative windshield wiper blade, but as their economy careens toward more complex and interdependent systems, the more likely it is to appear—perhaps in manifold, equally obscure, yet potentially more destabilizing ways. It would be stating the obvious to mention symptomatic miscues like Shanghai's managed yo-yo market or the recent unrehearsed volatility in the renminbi. It seems to be a force of nature that whenever any economic ideology reaches a peak in popularity, its denouement is not far ahead. Recall Japan after 1989, or Russia today—its GDP now one tenth that of the United States.

Faulting China is a poor excuse for failing to address the elephant looming in the rest of the world's backyard: The pervasiveness of centralized planning in the face of increased complexity has reached epidemic proportions, even while masquerading as its opposite. Starting here in the U.S., the centrally orchestrated, post-financial crisis recovery has failed to meet even the most modest of expectations. Worse yet, a litany of unintended side effects is likely to haunt us with a vengeance that makes the "drip, drip, drip" fallout from Hillary Clinton's email foibles seem like a drop in the bucket.

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[1] Paul Samuelson's *Economics* is the all-time, best-selling textbook of its genre. First published in 1948, the 19th edition was released in 2012.

Both at home and around the world, there is ample evidence of destabilizing forces at work:

- Geopolitically, the hopes of the "Arab Spring" that began in 2010 have faded into the despair of war-weary refugees fleeing to sister states and Europe for asylum, while the visceral threat embodied in the emergence of ISIS has risen to fill the vacuum. One might legitimately ask exactly what was the net contribution of advances, if that's the correct transitive verb, in communications technology.

- In a recent speech at the U.N., Vladimir Putin took aim at what he called the abuse, and sometimes abdication, of power by the U.S., the surviving hegemon (an imbalance of power that has a history of fomenting geopolitical instability).

- On to the latest in the globalization of trade, its increased complexity and interdependence has given rise to an insidiously increasing fragility in financial, currency, and related markets and institutions.

- Returning to governance in the U.S., what institutional message is implicit in the emergence of "The Donald"?

Harking back to where we started with the Basel Accords, it does appear that the rate of increase in the complexity of banking, economic, political, geopolitical and other institutions has outstripped the capacity of their presumptive leaders to govern or regulate them.

Shifting gears, but maintaining our philosophical discourse, Andy Haldane, the highly regarded chief economist for the Bank of England, wonders whether the comparatively anemic 1% advanced economic growth since the crisis, compared to 3% in the decade preceding it, is reason to worry about secular stagnation going forward—an idea that Lawrence Summers has trumpeted. Haldane (no doubt influenced by Thomas Piketty) reminds us that what is has not always been. Since 1750 living standards have doubled every 50 years, on average. Prior to 1750, it took 6000 years to achieve that same two-fold increase!

A conventional argument for the resumption of growth is that people will postpone consumption and accumulate savings for the long term (the adult version of the famous Stanford marshmallow experiment). Technological innovations will appear exogenously, savings will turn to investment and growth will follow.

A contrasting view is that growth will come from within the system, endogenously. This requires the simultaneous occurrence of several forces:

First, savers must believe that their act of deferred gratification is virtuous (as we've all been taught since we were in knickers), and, practically speaking, that it will result in more marshmallows at some later date.

Second, consideration must be given to the skill level of the workforce, out of which arose the inventors, scientists, engineers and entrepreneurs responsible for the leapfrogging advances in physics, chemistry, biology and medicine that were the building blocks of the Industrial Revolution. Today's ever-changing skill-set demands in technology must run in parallel with, and function complementary to, innovations in the physical sciences.

Last, and most subtle if not also most concerning, the institutional framework in which all of this takes place must be inclusive rather than extractive.[2] In economic terms, a danger lies in an institutional construct arising that extracts incomes and wealth from one subset of society to benefit a different subset. To return to Haldane's apprehensions about stagnation, while economic institutions are critical for determining whether a country is poor or prosperous (economic institutions shape economic incentives: the incentives to become educated, to save and invest, to innovate and adopt new technologies, and so on), it is politics and political institutions that determine what economic institutions a country has. Whether the well-publicized income and wealth disparities about which we've written[3] reach the boiling point could well depend on what happens politically in November 2016, or whether, before or likely after, the economy itself forces the issue to the fore.

From the Philosophical to the Practical

MCM is charged with the stewardship of client capital in a world beset with the abstract secular challenges touched on above. Neither can we deny them, nor can we let them overwhelm or distract us from the performance of our duties to you. We draw no small measure of comfort in the knowledge that, for all the upheavals that marked the 20th century, many adaptive businesses not only managed to survive, but thrive. These have been and, we believe, continue to be the safe havens we must seek out.

The first serious market tremors since 2011 became apparent in the last month, with the quarter just completed recording the worst market results in four years. In the face of all the emotionally-driven market volatility, pricing anomalies are occurring with much more frequency. In terms of the companies we aspire to own, their prices suggest a gradual migration from a seller's to a buyer's market.

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[2] Acemoglu, Daron; Robinson, James (2012-03-20). *Why Nations Fail: The Origins of Power, Prosperity, and Poverty* (p. 119). Crown Publishing Group. Kindle Edition. Because it is filled with real-time as well as historical examples, and sticks with understandable themes, in my opinion it is the equal of Paul Kennedy's *The Rise and the Fall of the Great Powers*, despite its relevance today because of what might be called hegemonic military overreach.
[3] "Deflation: A Possibility Not a Probability." Available upon request.

Third-Quarter 2015 Portfolio Review

	MCM Total Account Composite (net of fees)	S&P 500
3rd Qtr 2015	-4.7%	-6.4%
YTD 2015	-6.9%	-5.3%
Since Inception *	4.3%	3.7%

* Annualized, Inception Date 1/1/2000

Martin Capital Management's Total Account Composite declined 4.7% during the relatively tumultuous third quarter of 2015, during which time the S&P index fell 6.4%. Year-to-date our Total Account Composite performance was -6.9%, trailing the S&P 500 total return of -5.3%, as we sought bargains in more volatile sectors. As an absolute-return-oriented firm, we find no solace in these statistics, even though we realize that if one owns equities, one is subject to the short-term vagaries of the market. For the first time in four years, our client portfolios were buffered—not burdened—by holdings of cash and short-term Treasuries totaling 70.3% of assets. More importantly, the optionality of copious amounts of cash when others are fully invested is appreciated only when stock prices are falling. Unlike most of our brethren, we are exhilarated rather than increasingly anxious the more stock prices fall.

Overall, the 29.7% of assets committed to equities in our portfolio declined 20.1%. The table below shows individual holdings' price performance during the quarter. From our perspective, our equities became more attractive during the quarter. Some may see that statement as the equivalent to putting lipstick on a pig, but the world of investment opportunity looks different when over two thirds of your assets are in cash and not declining stocks. Without telegraphing our actions, we will be adding to new and existing positions as prices warrant, as well as pruning where we believe it is necessary.

As the ascent of the market flattened out in 2014, a number of economically or commodity price-sensitive sectors entered into their own bear markets, with many companies declining more than 50% from their highs. Equities whose earnings are sensitive to changes in the price of crude oil have made the headlines. Oil-related companies, which constitute 6.1% of the portfolio, reflect the volatility in that sector. Neither have equities outside the oil sector been immune to the volatility of late. A steep decline in a stock's price does not mean it's a bargain unless its underlying value has not been impaired. That's where we're spending our time.

Two companies that we already own are receiving much additional attention because our work thus far leads us to believe that the declines in their share prices do not reflect a deterioration in their intrinsic value. The decline in Garmin from $62 in mid-2014 to a recent low of $31 is a case in point. A pioneer in capitalizing on the GPS phenomenon in the mid-1990s, the stock peaked at $125 in 2007. With the advent of the smart phone, the PND (Personal Navigation Device) market is dying a slow death. A company either dies or becomes resilient and anti-fragile when the product line on which it built its identity and brand becomes a victim of Schumpeter's creative destruction. Hardly a one-trick pony, Garmin is proactive, constantly reinventing itself. R&D spending, which amounted to $395.1 million in 2014 (13.7% of total sales), employs 3,386 engineers, up from 2,558 in 2010. With no debt and lots of cash, the balance sheet is pristine. The founders own roughly 30% of the company and are the kind of stewards we seek out because of their total commitment to their fellow shareholders.

Colfax manufactures industrial products for global markets. From fluid handling systems, including oil and gas, to welding and cutting applications, as well as air and gas handling equipment, its products are those that most consumers never see. Founded by Mitch and Steve Rales (who are also the principal owners of the better-known Danaher Corporation), Colfax employs the same management philosophy as Danaher. Employing rigorous and, as some would say, ruthlessly exacting standards, they turn marginal businesses into profitable ones. Unlike private equity investors, they invest their own money and are long-term wealth builders. Because the company's end markets are cyclical, short-term oriented investors have fled. Since last summer, the stock has declined from $75/share to a recent low of $25/share. Mitch and Steve, as well as Warren Buffett's investment banker, Byron Trott, own 27% of the equity.

Not all price declines noted below are unwarranted. I made a mistake in buying Rayonier Advanced Materials. A spinoff from Rayonier Corporation, it proved to be a value trap. When one can't get close enough to understand thoroughly the motives behind the actions of managers—typically those with no skin in the game—one stands the risk of being fooled. Once we decide to exit a position, we are as disciplined and unemotional about that process as we are about making purchases. We bought on weakness and we intend to sell into strength, however great or small.

Company	Model† Position Size	Q3 Price Change††
Berkshire Hathaway Inc.	4.9%	-4.2%
Gentex Corp.	4.8%	-5.6%
Travelers Cos Inc./The	3.3%	3.0%
Wal-Mart Stores Inc.	2.8%	-8.6%
Garmin Ltd.	2.4%	-18.3%
Amgen Inc.	2.4%	-9.9%
Stryker Corp.	2.1%	-1.5%
Baker Hughes Inc.	2.0%	-15.7%
Noble Energy Inc.	1.7%	-29.3%
Helmerich and Payne	1.6%	-32.9%
Civeo Corp.	0.8%	-51.8%
Colfax Corp.	0.7%	-35.2%
Rayonier Advanced Materials	0.3%	-62.4%

++ Price Change reflects only the market price difference from the beginning of the quarter to quarter end. It does not include dividends and interest.

• The MCM Total Account Composite consists of all portfolios (or consolidated portfolios) with assets greater than $1 Million held in fully discretionary fee-paying accounts whose owners have given MCM the authority to invest up to 100% of the account in equities.

• The MCM Total Account Composite is managed in accordance with our Model Portfolio. The Model Portfolio is a representation of fully discretionary accounts positioned to conform to our ideal investment process. The primary investment objective for both the Total Account Composite and Model Portfolio is above average long-term growth in capital through a combination of capital appreciation and income, at below-average risk of permanent capital loss.

• Performance is shown Net-of-Fees. Assets are shown in US Dollars. ***PAST PERFORMANCE IS NO GUARANTEE OF FUTURE RESULTS.***

• The MCM Total Account Composite performance is compared to the S&P 500 Index. The S&P 500 Index consists of 500 stocks chosen for market size, liquidity and industry group representation. It is a market value weighted index with each stock's weight in the index proportionate to its market value. The reported returns reflect a total return for each year inclusive of dividends but exclusive of taxes and management fees.

As for activity during the quarter, we sold the remainder of our position in AbbVie (ABBV) before the market peaked and started its decline midway through July. Last quarter we commented that ABBV, a stock we received as a result of Abbott Laboratories splitting into two companies, was reaching valuations too high given the business's uncertainty and management's willingness to pay high prices for acquisitions. The price rose further and we subsequently sold the remainder of our position for $69.60/share. Having sold half the position in 2013, our average selling price was $57.16/share. We held ABBV stock for a little more than two and a half years and realized an annualized total return of 32.9%.

That was the only selling activity during the quarter, and while we didn't buy any new holdings during the period, we are ready to act when opportunities present themselves. Given our cash levels, as well as our confidence in the companies we hold and a number of others we would like to own, we believe we are in an excellent position to capitalize on an uncertain, volatile market and welcome the opportunities lower prices provide.

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